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The Pure Logic of Accounting: A Critique of the Fair Value Revolution

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The Pure Logic of Accounting: A Critique of the Fair Value Revolution

Yuri Biondi

Abstract

When international accounting standards were renamed to become international financial reporting standards, this seemed to imply that accounting no longer needed to exist, but rather had to be reconsidered as a part of financial communication and advertising. Does traditional accountability no longer matter? Betrayed investors and globalized stakeholders would dissent. A difference of nature continues to exist between fair values disclosed by managers and certified by auditors, and the actual performance generated by the enterprise entity through time, space, and interaction. In a world shaped by complex organizations facing unfolding changes, hazard and limited knowledge, the quest for fundamental principles of accounting is not academic. Accounting principles constitute a primary way that the creation and allocation of business incomes is governed; that is, fairly managed and regulated in the public interest, having respect to "other people interests." This article adopts a dualistic posture that opposes the accounting conceptual frameworks based on fair value (market basis) and historical cost and revenue (process basis). The fundamental premises about the underlying economics of the enterprise entity are discussed, including the representation of the business and the concepts of asset and liability. References are made to the case of accounting for intangibles, and to the distinction between equities and liabilities. The cost and revenue accounting perspective is then defended in terms of accountability, but also from the informational viewpoint: historical accounting information plays a special role as a lighthouse in the dynamic and strategic setting of the Share Exchange. In particular, two refinements of the historical cost (and revenue) accounting model are suggested. The first one regards the treatment of earned revenues from continuing operations, and the second, the recognition of shareholders' equity interest computed on the actual funds provided in the past, coupled with the distinction between shareholders' equity and entity equity.

KEYWORDS: accounting theory, international financial reporting standards (IFRS), intangibles, conceptual framework, accounting principles and rules, accounting standards, marked-to-market, fair value, marked-to-models, accounting regulation

JEL Classification Codes: D23, L22, M41

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1. The ongoing shift from cost to fair value accounting

Since 1973, major accounting regulatory bodies such as the FASB and IASB have been fostering an accounting revolution. The traditional accounting model based on historical cost has been progressively displaced, disbanded and replaced by new premises and concepts related to a new fair value accounting model.

In effect, the old language of business is being to be replaced by a new language under the pressure of independent regulatory authorities. This scenario recalls what George Orwell wrote in his masterpiece "1984" about the drift from "Oldspeak" to "Newspeak". One of the distinguishing aspects of this replacement is to make any alternative thinking or speech impossible by removing words or possible constructs which describe the old fashioned ideas of matching, reliability, enterprise entity and going concern, historical transactions and so forth. By 2020 — earlier, perhaps — all real knowledge of the old language could have disappeared. The whole literature of the past could be destroyed. A. Charles Littleton, J.W. Eugen Schmalenbach, Gino Zappa, Heinrich K. Nicklisch, Robert N. Anthony, Yuji Ijiri — they may be neglected and exist only in new language versions, not merely changed into something different, but actually contradicting what they used to be.

From this perspective, the change of name from "International Accounting Standards" (IAS) to "International Financial Reporting Standards" (IFRS) appears to involve a paradigmatic shift. Accounting might not any longer (need to) exist, but should be reconsidered as a part of overall financial communication (and advertising) for financial markets.

Does "accounting" -as accountability- no longer matter? Betrayed investors and globalized stakeholders would dissent. A difference of nature continues to exist between fair value "revelations" disclosed by managers and certified by auditors, and the actual financial performance and position generated by the enterprise entity through time, space, and interaction. Therefore, the debate is still fierce today (AAA FASC 2005, 2007a, 2007b). On 17 November 2005, the IASB published a discussion paper devoted to "Measurement Bases for Financial Accounting – Measurement on Initial Recognition" (hereinafter, IASB DP 2005). During a six months comment period, eighty-four comments letters were received. As summarised by the IASB's report (2006c), "the majority of respondents are not supportive of the paper's overall proposals regarding the relevance of fair value on initial recognition (63%), although some of these respondents support individual aspects of the proposals, and several respondents have mixed concerns (12%). Only a small minority support the paper's proposals overall (17%)". Unsupportive respondents include major accounting regulatory bodies from France, Germany, Italy, and Japan, and leading accounting professional firms such as Ernst & Young, Grant Thornton and Mazars. Respondents appeared to be fully aware of the major implications of the revolutionary change of accounting model that was advanced. The Orwellian linguistic strategy underpinning that change was then addressed. They questioned the IASB DP (2005)'s preference for fair value as a deductive consequence of an alleged set of premises and concepts that was formulated in a way that already implied that preference whilst preventing the related issues from being discussed. Therefore, they criticized the way questions were addressed and asked for a clearer understanding of what the business entity's statements of financial performance and position should portray.

This article contributes to this ongoing effort of conceptual clarification by drawing upon theoretical debates that have been going on for at least a century with respect to fair (current) value versus historical cost accounting. In particular, it will address the accounting representation of the economics of the business entity that each alternative accounting conceptual framework (model) underpins. This representation relates to the respective definitions of the notions of business capital and income, their "capital maintenance" concepts and their implications for income recognition. More generally speaking, this exercise in clarification involves a broader discussion of the nature and role of business entities -and of their accounting structure- for economy and society. From this perspective, the whole issue of measurement derives its meaning from understanding the fundamental principles of financial accounting, including their implications for relevance and reliability and its informational content. In "Newspeak" wording, this paper is concerned with the bases and implications of the so-called "objectives" and "qualitative characteristics" of "financial reporting."

The remainder of this paper is organised as follows. A dualistic approach is adopted that opposes cost (and revenue) and value as distinct bases, which imply distinctive premises and frameworks of reference. The respective accounting logic and model are then compared. In particular, the first section will examine the accounting logic in order to better understand the distinctive role that accounting plays in the socio-economic system. The analysis will then contrast the "value relevance" approach with the "accountability" approach to accounting for businesses and society. On this basis, the second section will delve into the accounting model by analysing the fundamental views of the economics of the business enterprise addressed by cost and value accounting perspectives. Starting from this comparative analysis, the distinctive impacts of the two accounting perspectives are explored in some specific cases. The third section will discuss the case of the accounting for intangible assets and the distinction between equities and liabilities. The fourth section will address the question of accounting information for financial markets and the implied concepts of relevance and reliability with regard to the underlying accounting perspectives. Some heuristics for improved financial statements will be presented, including two refinements of the cost and revenue accounting model. The first regards the treatment of earned revenues from continuing operations, and the second, the recognition of shareholders' equity based on the actual funds provided in the past, coupled with the distinction between shareholders' equity and entity's equity. A summary of the main argument concludes.

2. Accounting for business and society

La comptabilité commerciale est une des plus belles et des plus heureuses applications de la métaphysique.

P.-J. Proudhon, « Système des Contradictions Economiques, ou Philosophie de la Misère », Tome II, chap. X : Le crédit, Paris 1846, p. 159-60. [1]

Business accounting is one of the most beautiful and important applications of metaphysics.

2.1 The role of accounting principles in forming accounting standards

In a world shaped by ongoing organizations confronted with unfolding changes and limited knowledge, the quest for accounting principles is not academic. Accounting principles constitute the primary way that business relationships are governed with respect to "other people interests."[2] Such principles have an impact on how business enterprises are conducted, costs are established, profits are shared, taxes are paid, dividend distribution is calculated and permitted, financial capital is maintained, and prudential covenants are enforced. They ultimately affect the mode of generation of income to the business enterprise and its allocation among the different stakeholders (including shareholders) through time, space, and interaction.

Financial accounting standards are driven by the frame of reference created by these principles, i.e., by fundamental premises and concepts. Standard-setters, practicing accountants, auditors, financial analysts, financial statements users and law court judges refer to accounting principles in order to properly comprehend accounting numbers. They use these numbers not only to value firms in the Share Exchange, but for many institutional, organizational, and cognitive matters. From the institutional viewpoint, the accounting structure applies in

[1] Appreciated by A.A. Berle jr. and harshly criticized by K. Marx, Pierre Joseph Proudhon (1809-1865) was a leading French economist during the XIX century.

[2] According to Adam Smith, the management of the affairs of a public company is concerned with "other people's money", and this may eventually lead to negligence and profusion.

constraining dividends and equity repayments, maintaining regulatory equities, establishing taxes, and enforcing prudential ratios and covenants. In addition, the accounting numbers are used to construct measures of financial performance such as Economic Value Added (EVA), price to earnings and book to market ratios, which are highly influential for management and governance of the business firm. From the organizational viewpoint, accounting structure and numbers play an important role in the behavioral and incentive structure of the firm through budgets, employee compensation and bonus schemes. From the cognitive and epistemic viewpoint, accounting - by representing the invested business capital and generated income - plays a role in how and what actors know about the ongoing enterprise that constitute their joint concern.

Accounting and accountability are by no means unconcerned with socio-economic polity. They are an integral part of the governance and the regulation of the socio-economic system. The consequences of one accounting standard or another may induce one particular type of behavior or another, and also privilege some stakeholders as compared with others in the context of the enterprise entity. Accounting principles must therefore facilitate establishing a level playing field, both inside and outside the firm. Unsatisfactory principles lead to unsatisfactory standards and incomprehensible accounting reports. Accounting standards need a framework for the same reason that a legal system needs a constitution to guide the development and application of its laws. According to the definition provided by the FASB (1976, 2):[3]

> [A conceptual framework is then] a constitution, a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function and limits of financial accounting and financial statements.

Without a framework, each standard approaches a specific problem on an ad hoc basis, arguing from premises and concepts that are not made explicit, and which may be inconsistent with another standard, or with the overall purposes of the accounting system (Anthony 1987). This would undermine the comprehensive representation of the whole enterprise entity that must be accounted for economy and society.

[3] This constitutional view is actually at odds with the current authoritative status of the conceptual framework that is adopted by both FASB and IASB, since specific standards prevail on the framework and may be inconsistent with it (see IASB 2008, P8-P11).

2.2 What does "fair" mean for accounting principles?

When these socio-economic implications are considered, the accounting "Newspeak" seriously risks obscuring the very nature of the logic that accounting principles are intended to establish. From this perspective, expanding upon Williams (1987) and Thaler and al. (1986), accounting principles should be "fair," because they constitute an integral part of the governance and regulation of business affairs. "Fairness" requires going beyond the formal application of rules -as detailed they might be-, because the protection of interests goes beyond the contractual enforcement of rights and claims. In a world of pure law, every business activity is controlled ex ante by external forces driven by immediately enforceable rules and contractual claims. A striking analogy exists between pure law and the theory of pure market as adumbrated by IASB DP (2005), where prices suffice to secure the socio-economic interests for each stakeholder linked to the business enterprise. Every business activity is then controlled ex ante by external forces driven by the price mechanism and monetary incentives. In contrast, in a world of complex organizations concerned with unfolding changes and limited knowledge, every ongoing entity generates a financial-economic core existing beneath the shape provided by contracts and prices. Within this core, contracts are incomplete, and markets are never perfect. In the void left by contractual incompleteness and market failures, the firm acquires a dynamic and collective dimension that leads to a field of overwhelming power (Sakatera and Sawabe 2000; Biondi et al. 2007). As Berle early recognized, a merely legalistic reasoning cannot deal with this power, because the formal conformity to rules may hide unfair behavior, fraud and abuse. This situation is at the very origin of the legal-economic meaning of the expression "equitable interest," that is, a legitimate interest that the bearer might be unable to defend through contractual enforcement of rights and claims.[4] Accounting principles fill in that void in order to address the "equitable interests" of stakeholders relying on the firm for the joint accomplishment of their goals, while substantially, even though not formally, lacking in contractual enforcement or market outward option. Furthermore, accounting principles complement accounting standards (i.e., rules) since the application of rules involves discretion and judgment. Accounting principles lie at the core of the institutional process of protection, since they provide each actor (especially management and law court judges) with a clue to comprehending the socio-economic dynamics of the joint concern and for undertaking the fair conduct of business. This conduct is "fair" because it takes into account "other people interests" and thus has regard for the public interest at large. Fairness

[4] Montagne (2006, 46 ff.) deals with the emergence of the notion of "equity" and "equitable interest" in trust regulation.

cannot be narrowly *reduced* to economic value, but ultimately drives the even-handed choice and application of principles of reference for the "language of business."

2.3 The nature of accounting pursuant to the accountability perspective

The traditional accountability framework that supports historical cost (and revenue) accounting is based on the three classic accounting principles of (i) the firm as an entity and a going concern, (ii) matching, and (iii) invested cost and generated revenue.

According to Hoarau (2007:43), the principle of the firm as an enterprise entity has been universally accepted in all countries and regulatory contexts. According to this principle, the firm is considered to be a socio-economic institution and organization that has functional autonomy from its stakeholders, including shareholders. This implies that the notion of "ownership" is meaningless in the enterprise field, since no one "owns" the business firm (Raby 1959; Scott 1979; Biondi et al. 2007). According to the matching principle, the firm generates revenues that are allocated among stakeholders, including suppliers, employees and shareholders, through time, space, and interaction. Having regard to the mutual fairness and the protection of the continuity of the joint concern, these revenues are determined starting from the *actual* monetary flows that have been transacted for and which constitute the fair basis for costs and revenues. These revenues are generated only in historical time. This is why the principle of invested or historical cost is coupled with matching. According to these classic principles, accounting disregards changes in capital values and shareholders' wealth, i.e., the stock method, to focalize on generation of revenue (income), i.e., the flow method. The underlying economics of the business firm is not considered by measuring the entrusted wealth and related (quasi-)rents (i.e., changes of value), but instead by representing its economic and monetary process as an enterprise entity.

2.4 The drift away from classic accounting principles

In contrast, the fair value perspective advocated by IASB DP (2005) adopts a market view. This view supposes that the business entity is framed in a world of market forces capable of addressing and solving its accounting issues. The traditional focus on the economic and monetary process of the whole enterprise entity tracked through time is then replaced by a focus on separated marketable assets and liabilities that compose its wealth at an arbitrary moment in time. The definition of historical cost is then restated as follows:

> Historical cost: Assets are recorded at the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the fair value of the consideration received in exchange for incurring the obligations at the time they were incurred. (IASB DP 2005: 37).

Whilst the previous IASB Glossary and Framework stated (*ibidem*):

> "Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given…"
> "Liabilities are recorded at the amount of proceeds received in exchange for the obligation".

Every reference to the nominal values that arise from actual monetary flows established by accomplished transactions is removed from the accounting conceptual framework. Even the notion of economic entity is displaced. The entity is no longer understood as a socio-economic institution and organization (Raby 1959; Sakatera and Sawabe 2000; Biondi et al. 2007), but rather as a legal person or device acting on behalf of its proprietors. Moreover, the economic substance is disregarded in favor of the legal form. For example, the definition of control utilized in the new standard for business combinations is increasingly based on legal and legally-enforceable forms of control (IFRS3, §7; former IFRS3, §19; former IAS 27r, §13), and the IASB has "tentatively decided to change the definition of control to focus on an entity's assets and liabilities rather than the entity itself" (Tweedie 2006: 14). In the same spirit, the fair value option for certain financial assets and liabilities (FAS 159) can be elected on a contract-by-contract basis, and not at the entity or account class level.

2.5 A defense of classic accounting principles

Therefore, independent regulatory authorities are being to impose a major departure from classic accounting principles to economy and society (Biondi and Suzuki 2007). This is especially sensitive since, following FASB CON 2 (par 98), "accounting information cannot avoid affecting behavior, nor should it," for accounting principles do affect modes of management, stewardship and governance.[5] The accounting representation cannot be "neutral" with respect to the underlying activity, that is, it cannot rest "without influence on human behavior" (FASB CON 2, *ibidem*). Unlike an image in a mirror, the accounting representation shapes and frames the working of the enterprise entity. The

[5] The two latter terms refer to the duties and responsibilities of management towards proprietors. This is why the term accountability is preferred here to recall the broader scope of accounting for business and society.

ultimate consequence is that real decisions are influenced by the accounting numbers (Hines 1988, 1989; Bignon et al. 2004; Plantin et al. 2007; AAA FASC 2007b). In particular, the accounting system affects the economic and monetary processes of the business firm *regardless of the accounting perspective (or model) applied*.

If accounting cannot remain without influence on business and society, accounting principles *should* make business entities accountable and comparable in accordance with the public interest. The formulation and implementation of an accounting system are not only technical matters, but are concerned instead with the "language of business," which is embedded in the making of the socio-economic system, where language mediates and maps context (Ijiri 1975; Hopwood 1983; Laughlin and Puxty 1983; Roberts and Scapens 1985; Williams 1987, 2004; Lavoie 1987; Robson 1992; Capron 2005; Cunningham 2005). As advocated by AAA FASC (2007b: 192), "standard setters should [then] consider some of the broader economic consequences of a move to a fair value accounting regime." When these broader consequences are considered, the market perspective adopted by fair value accounting appears to disregard the special economics of the business firm. Because they are embedded in the socio-economic system, business entities are especially concerned with "other people interests," since they are special modes of generating and allocating revenues (and incomes) among stakeholders, including shareholders, through time. In this special socio-economic environment, *the accounting system complements and replaces the price system that, following Adam Smith, protects people outside the enterprise field*. This special role of accounting in business and society places it in a different position from other forms of financial reporting. Whilst some forms may be combined with financial communication and advertising, accounting remains an integral part of the cognitive and epistemic, organizational and institutional "structure(s) of production" (in Coase 1991's terms). The accounting system characterizes the special economics of the firm in a way that differs from that of external markets, and influences its dynamic creation and allocation of revenues and incomes through time, space, and interaction (Sunder 1997; Sakatera and Sawabe 2000; Biondi 2005, 2006, 2007).

According to the fair value perspective, the main purpose for accounting is "value relevance" and "decision usefulness" for capital markets participants. This points draws upon the naïve presumption that,

> as investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy. (IASB, Framework 1989, §10).

> Other parties, such as regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful. However, those reports are not primarily directed to these other groups. (IASB, Framework 2010, §OB10)

This implies both a doubtful alignment of financial information on an alleged viewpoint common to all investors, and a lack of consideration of the whole entity's economy that investors have committed to (Ijiri 1975; Anthony 1983). The fair value perspective appears to be at odds with the nature and role of enterprise entities that actually are socio-economic systems involving continuing relationships among interested parties and which raise public interest concerns. In constrast, the classic accounting principles fit a broader "accountability" framework that recognizes the socio-economic nature of business entities. Accounting is then understood as a mode of representing, organizing and regulating these socio-economic systems and their institutional, organizational, and cognitive patterns and interactions. Even in the absence of the discipline of the market, accounting and accountability assume an active role in governing and regulating management and the organized activities of the enterprise entity as a whole.

This section has disentangled two distinctive accounting perspectives, either fair value or historical cost (and revenue). It has argued that the accounting system matters for business and society through the structuring role that it plays in the economics of the business firm. This claims for a clearer understanding of the representation of the business enterprise implied by each accounting logic and model that will be developed in the following section.

3. Accounting for the economics of the business enterprise

Le comptable, pour tout dire, est le véritable économiste à qui une coterie de faux littérateurs a volé son nom sans qu'il n'en sût rien, et sans qu'eux-mêmes ne se soient jamais doutés que ce dont ils faisaient tant de bruit sous le nom d'économie politique, n'était qu'un plat verbiage sur la tenue des livres.

P.-J. Proudhon, « Système des Contradictions Economiques, ou Philosophie de la Misère », Tome II, chap. X : Le crédit, Paris 1846, p. 159.

The accountant, to be sure, is the true economist from whom a number of petty writers have robbed the title without him knowing, and without them having any guess that all their jazz about political economy was nothing but an annoying verbosity about bookkeeping.

3.1 An alleged market reference

The accountants, who are encouraging the fair value revolution, do not esteem accounting itself very much. Instead, they look to financial economics as the proper foundation for their accounting model. Accounting is then assumed to be a part of the information required by capital market participants to predict current values based on the future, which is supposed to be the proper basis for financial decision-making. Financial economics does not purport to understand the special economics of the business enterprise. On the contrary, it views the firm as being located in a world of complete and perfect markets in equilibrium. This framework allows the *price system* alone to dominate the firm, when creation and allocation of resources are concerned (Biondi 2005, 2006, 2007). Therefore, not only does its income, but the whole firm does not exist; rather it is disintegrated into a collection of disparate assets and liabilities having no comprehensive connection but distinct efficient pricing.

The problem with fair value accounting relates to this view about markets and the firm. According to Shubik (1993), time and uncertainties have essentially disappeared from this apotheosis of the price system, but they remain the actual concern of everyday business activity. The problems related to accounting for the influence of time and complexity in the ongoing enterprise process is central to the development of accounting. The fair value approach trusts the price system to reflect the economy of the ongoing business enterprise. However, market prices may not be the right cornerstones in the enterprise context; as a matter of fact, they often do not exist for most elements and transactions. Therefore, when the fair value approach is applied to the enterprise context, the intricacies of forecasting enter into the accounting field through the use of current values and mark-to-model values; the accounting system is then required to recognize profits earlier and earlier (Ijiri 2005: 259-263).

This section will discuss the economic consequences of the application of the fair value accounting logic for the representation of the business firm. The accounting logic provided by the historical cost (and revenue) model will be adopted as contrary perspective. This will lead to a confrontation of, on the one hand, the implied understanding of the economics of the business firm; and on the other hand, the concepts of asset and liability that belong to the respective accounting models.

3.2 Accounting: Financial or Economic?

The votaries of fair value grapple with keeping some notional reference to the value of the business enterprise as a whole, but their method implies a disintegration of the business into a collection of separate assets and liabilities.

> Although investors and creditors are generally interested in net cash-equivalent flows of the entity as a whole, those amounts are the aggregate of a number of individual cash-equivalent flows related to individual assets and liabilities, or related groups of assets and liabilities, within the entity (IASB DP 2005: 30).
>
> (§OB2) The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity […]. (§OB3) Decisions by existing and potential investors about buying, selling or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments, for example dividends, principal and interest payments or market price increases. […] Consequently, existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity. (IASB, Framework 2010, §OB2 and §OB3).
>
> Some future cash flows result directly from existing economic resources, such as accounts receivable. Other cash flows result from using several resources in combination to produce and market goods or services to customers. Although those cash flows cannot be identified with individual economic resources (or claims), users of financial reports need to know the nature and amount of the resources available for use in a reporting entity's operations. (IASB, Framework 2010, §OB14).

This approach does not seem appealing for understanding the actual environment where firm's operations are conducted. From the legal-economic viewpoint, enterprise entities are not financial trusts, nor portfolios of disparate (groups of) assets and liabilities, but ongoing economic activities whose legal form relates to partnerships, corporations and combinations of them in enterprise groups (Biondi et al. 2007; Strasser and Blumberg 2010; Robé 2010).

Furthermore, the "cash fits all" objective mentioned by the previous quotations is reduced when the role of accounting in the working of the socio-

economic system is considered. The accounting system is not only concerned with disclosing information on a financial security, but it is also an integral part of the "institutional structure of production" that affects the generation and allocation of enterprise income through time (Coase 1990, 1992; Modigliani and Miller 1963; Bignon et al. 2004; Biondi 2005; Plantin et al. 2007). Accounting numbers are utilized not only to value firms in the share and credit markets, but for many organizational, institutional, and cognitive needs. The accounting system relates to the process of creation and allocation of resources within the enterprise. Accounting is not only financial, but also economic: It is useful for costing and profit-sharing (including employee compensation and bonuses); for calculating and constraining dividends, maintaining financial capital, establishing taxes and enforcing prudential reserves and covenants; and for representing business capital and income to managers and stakeholders.
As Littleton (1956: 23) stated:

> [One Accounting belief is] that income cannot arise directly from new investments or borrowings, or by action of owners in creating an item in their accounts called "goodwill," or by owner action in repricing assets already possessed. The reason for this view […] is that no service has been rendered by this enterprise in connection with these purely financial actions."

This accounting belief implies that the whole set of financing and investing activities (represented by the balance sheet) can never generate economic income to the firm. This income results from the overall business activity and is represented by the whole of the costs and revenues matched to the period of reference by following the enterprise entity's process (as represented by the income statement). Accounting requires a comprehensive approach that represents each transaction, operation, combination or event according to the role it plays in the overall enterprise entity through time. This approach contrasts with fair value accounting for disparate accounting elements having their own separate existence. Even an early developer of the fair value concept like Bonbright (1937, chap. XXVII, 912 ff.; chap. XXVIII, 976 ff.) argued in favor of the cost accounting approach when the institutional determination of generated income is required, especially with regard to the declaration of dividends and the determination of tax basis.

3.3 The overarching accounting logic

The fair value approach implies a special accounting representation focusing on the creation of wealth that has a market basis. Market prices are considered to be the measure of value of every asset or liability. As a result, this approach requires evaluating each asset and liability in isolation according to the discounted present value of its own future cash flows (Table I).[6] The preference for fair value is motivated by this piecemeal valuation which does not consider the whole entity and the overall representation of business capital and income to the firm. The business entity disappears as a going concern, and is reformulated as a legal device that possesses in trust a collection of assets and liabilities on behalf of its investors.

This perspective appears to rest upon the old idea of trusts and estates. The stockholder was the beneficiary, profit was the income of the estate, and the capital was the corpus of the estate. According to the IASB DP (2005):

> Financial statements also show the results of the stewardship of management, or the accountability of management for the resources *entrusted* to it (IASB Framework, par 14, quoted by IASB DP 2005: 26, italics added).
>
> Management of an enterprise is periodically accountable to the *owners* not only for the custody and safekeeping of enterprise resources but also for their efficient and profitable use (FASB CON 1 par 50, quoted by IASB DP 2005: 27, italics added).

From this patrimonial perspective, the role of management is to be the steward of the firm's net assets and accountable only to the owners. The exclusive purpose of the firm (which is then understood as a financial trust) appears to be exclusively the monetary enrichment of its beneficiaries:

> The conceptual frameworks for financial reporting are founded on presumed economic purposes of business entities. It is presumed that, for financial reporting purposes, the primary purpose of business entities is to create wealth. Business entities create wealth through the production and sale of goods and the provision of services. *The various means of creating wealth do not affect this purpose of business entities.* (IASB DP 2005: 30 and note 12, italics added).
>
> Business enterprises, like investors and creditors, invest cash in noncash resources to earn more cash (FASB CON 1, par 39, quoted by IASB DP 2005: 30).

The firm is considered to be a property interest held by managers for the benefit of investors as beneficiaries. On this basis, the accounting system purports

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[6] The discounted value is assumed to be subsumed by current market price whenever an "active" market exists, see below.

to inform the investors about the fair value of the collection of assets and liabilities. Each valuation is supposed to be "timely", that is, to refer to an arbitrary point in time. Successive valuations may be reported and compared, but no logical connection exists among them.

Table 1 – Accounting logic

	Fair Value	**Cost (and Revenue)**
Focus	Wealth	Income
Conceptual Basis	Market	Enterprise process
Approach	Value	Cost (and Revenue)
Epistemological foundation	Individualistic, spot valuation (asset or liability in isolation)	Comprehensive (holistic) representation system (asset or liability in combination)
Methodological basis	Actualization (Discounting)	Matching
Perspective	Value Relevance	Accountability
Reference	Stock	Flow

In sum, the fair value approach implies a representational focus that is very different from the traditional accounting focus on accountability. The main differences include the approach to the enterprise process confronted with time, space, and interaction, the choice between value and cost, and a focus on entrusted wealth or generated income.

3.4 Accounting for the enterprise process

Regarding accounting for the enterprise process, the fair value conception refers to *current values* that always imply a present value calculation based on discounting future cash flows. Fostered by the colonization of financial reporting by financial economics, the focus is on the arbitrary instant at which the calculations are made and disclosed. In contrast, the traditional accountability logic recognises the firm as an ongoing business entity, and the comprehensive temporal connection among assets and liabilities, revenues and costs is taken into account (Table I). The accounting system is then expected to look towards the intricacies of the business firm as an enterprise entity located in time and space, a unique environment fundamentally different from the markets of reference.

From the historical cost perspective, accounting is not made dynamic by taking into account the current value of an imagined future; instead it refers to the accrual of *actual* expenditures related to the ongoing productive process of the enterprise entity. These expenditures become the historical or invested costs that are *intended* to jointly generate business income for the enterprise entity in historical time. Financial reporting purports to disclose a reliable synthesis of this process and its results. The arbitrary division of a continuous business process into periods does not presume the overall notion that financial reports are arbitrary, but rather intermittent portrayals of a firm in what is a continuous linking of an intentional chain through time and space and confronted with unfolding changes and limited knowledge.

3.5 Accounting for value (stock) or cost (flow)

Regarding the choice between cost and value, the cost accounting perspective argues that current values do not constitute the proper basis for accounting since the valuation of separable assets and liabilities does not result in a consistent representation of the whole economics of the ongoing firm. The fair value approach purports to represent changes in value. In contrast, the cost accounting focus is on the actual generation of incomes to the enterprise entity though time, incomes which may be allocated to different stakeholders, including shareholders. The accounting basis is no longer provided by external markets, but by the economic and monetary process implied by the whole business activity. Following this process, costs and revenues are determined starting from actual monetary transactions, past or future.[7] Market prices are then reconsidered in terms of money flows related to *actual* exchange transactions through time, instead of current market values.[8] These monetary streams are reconfigured within the accounting representation through the matching process in order to determine the business income generated during a particular period of time.

3.6 Accounting for wealth (stock) or incomes (flow)

Regarding a focus on wealth or income, the ways that money enters into and exits from the business through time do matter for the cost approach. The main distinctions are then between cash outflows (exits) that are either treated as expenses or invested as assets, and between cash inflows (entries) that are either revenues or sources of financing (Biondi 2005, 2006, 2007). The ways in which wealth is created also matter, in that the overarching scope is not on financial wealth creation but on the socio-economic role of the enterprise in satisfactorily

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[7] The overall accounting representation is not limited to transactions, but includes operations, combinations and events.

[8] According to AAA FASC (2007a: 234), "numbers that are not grounded in actual market transactions that can be audited for veracity usually are not trustworthy".

responding to individual and collective needs. According to Schmalenbach (1926, part D, §4, p. 85, our translation):[9]

> The economic function of business-making is not to be or become wealthy (reich); and whoever goes on counting (zählen) his worth (Vormögen) makes unproductive work (unproducktive Arbeit).
> Nonetheless, income (Erfolg) should be accounted for and kept being accounted (messen). For the economic function of business-making is to produce, transport, store and sell goods (Güter) until the last man, and to do all this economically so that the means (Stoff) of such endeavor do not wear out in the process.

The business entity is expected to have value as a whole depending on what it will produce and sell in the future. The priority is given to the determination of the income generated by the productive process, and not to the expected change in value. Accordingly, Littleton (1953, 24) considers the following accounting principle of enterprise service:

> Business enterprises are accepted and used because they perform [an] effective economic function in supplying goods (for living) and employment (for earning).

From this perspective, enterprises are not necessarily expected creating wealth, at least if wealth creation means to accumulate financial wealth for their owners.

3.7 The accounting model: the notions of asset and liability

These different logics of fair value and historical cost correspond with different representations of the basic elements of the accounting system. The fair value model represents assets at the discounted present value of the future monetary inflows, whilst liabilities are represented at the discounted present value of the future monetary outflows (Table 2). This would be appropriate if accounting represents the value of a collection of disparate assets and liabilities, instead of the legal-economic congeries of the business enterprise that generates income in historical time.

[9] Cf. also English edition (1959), p. 30-31; last German edition (1962), p. 49.

Table 2 – Accounting Model

	Assets	**Liabilities**
Fair value Model	Future monetary *inflows* discounted	Claims against future monetary *outflows* discounted
Cost (and Revenue) model	Actual monetary *outflows* (expenditures) capitalized	Advances on future monetary *inflows* (through time)

What would happen if a fair value accounting model applied to the economic and monetary process of the enterprise entity?

3.8 The liability side

Take the liability side. A provision for future disbanding of nuclear equipment is required by the French regulatory context. Table 3 shows the accounting for this provision by a leading power enterprise in France.

Table 3 – Provision for future nuclear charges (obligation for environmental cleanup) to 31 December 2003

Million euros	Estimated Future Cost (Nominal)	Fair Value (Discounted)
EDF	48 006	24 787

Reference: Report by the "Cour des Comptes" 2005, cf. Biondi et al. (2008)

At the representational level, a provision for a future charge is supposed to be the accounting way of securitizing the related promise to pay this charge in the future. It purports to establish a priority of this payment with respect to other current or future payments from income generated by the firm. Accounting for this provision at its fair value results in postponing a large part of its impact on the enterprise income until future periods; that is, to delay the economic payment of the provision to future enterprise results. This delay weakens the priority claim of that obligation. Only the discounted sum is paid out by current income which then has a priority on further income allocations after the current period. Careless managers might distribute the necessary income in the future, and the capacity by the enterprise entity to face the outstanding liability would be then reduced.

Generally speaking, this implies that the measurement of liabilities at fair value does not correctly disclose the outstanding debt exposure and scheduled debt service of the enterprise entity. Fair values synthesize in one net value number all future inflows and outflows in a way that is useful for estimating the current value of a business, but that is unable to properly account for the ongoing monetary matching of these flows. In addition, their synthesis in one value does not provide any understanding for the economic meaning of these flows: It leads to the paradoxical result of increasing earnings (and solvency ratios) when the credit risk goes up, and vice-versa, as stressed by Krugman (2009). In contrast, the classification of monetary flows between revenues and expenses, assets and liabilities served that understanding, in the historical cost approach.

At the conceptual level, the fair value approach muddles the economic meaning of the notion of "liability." Focusing on the fair value of a liability means evaluating it as a debt held by the entity on behalf of its investors. But the entity is not holding that debt, contrary to the concept FASB CON 7 (par 76), which states: "To estimate the fair value of an entity's (financial liability), accountants attempt to estimate the price at which other entities are willing to hold the entity's liabilities as assets". From the entity viewpoint, the liability consists in a claim for funds that have been committed. This is why the cost model recognises the monetary amount that has been advanced and anticipates future monetary inflows capable of recovering that amount. In contrast to discounting, which blends capital and interest flows in a unique capital stock value, capital flows are then recognised in the balance sheet through distinguishing between the financial inflow (liability or equity) and the capitalised expenditure (asset), whilst the interest flow is recognised in the income statement.

Finally, from a regulatory viewpoint, according to Peasnell (2006: 2, note 3): "an unrestricted application of fair value to all liabilities would run counter to the provisions of the 4th [European] Directive and as such would breach the accounting regulations set out in the company laws of member states of the European Union." More generally speaking, fair value accounting may cause to disconnect financial accounting and reporting from the regulatory framework (including dividend calculation and allowance, capital maintenance, prudential reserves, taxation). This would result in both raising costs by requiring several accounting systems with disparate figures, and in muddling the common understanding of financial performance and position of the business firm.

3.9 The asset side

Take the asset side. Obviously, assets are investments made in search of a benefit; but is the latter actually realised? According to Ijiri (2005: 259-263), cash accounting waits for cash realisation and avoids forecasting, since profits and losses are actually realised. Under cost accounting, estimates are based on delivery of products or entitlement to cash. The degree of assurance weakens. Under accounting for current value on the market, sales may not be either delivered or entitled. Profits and losses are then only potential, and the assurance is increasingly weak. Furthermore, when accounting using mark-to-models is allowed, profits and losses are determined before any economic activity, i.e., before any production and selling of products and services.

Drawing upon this distinction according to different levels of abstraction from the cash basis, the shift from cost basis towards the current value basis or beyond (collectively called here "fair value" basis) can have a tremendous impact on the process of economic decision-making. From the fair value perspective, an asset represents a value potential that incorporates future monetary inflows. The knowledge of this value potential is assumed to be useful for investment decision-making. For example, an asset can be created by the economic decision of buying a theatre ticket through a reservation made one week before. If the cost was $10 and we can assume, in absence of contrary evidence, that the decision-maker has acted rationally, that is, the expected value of the ticket (allowing for the theatre event) exceeded its cost. If on the event day, however, a rainstorm occurred, and the decision-maker suddenly decided not to go; this may be another rational decision, since the expected value was modified by the changed conditions. However, the subjective economic *values* (which led the economic decision) inherent in the theatre operation do not appear to be accountable, from the cost accounting viewpoint. The accountant would write off the asset and recognise the loss of $10, since the ticket no longer has use value. In addition, the disclosed information about resulting profits and losses may be useful (relevant) to the present and to the potential investors interested in entering the enterprise field managed by that decision-maker.

Therefore, accounting for assets at their fair value (whether current or expected) displaces the traditional accounting role of recognising the eventual realisations that may be checked against subjective expectations. The cost accounting model does not require recognizing 'unrealized' incomes which are generated according to the external market reference, at least until the benefits are actually realised by the ongoing enterprise process. "Realized" incomes are reliable and conservative, and also indicative of performance as a matter of enterprise entity operations.[10] On the basis of disclosure of generated incomes, the firm's employees used to negotiate their salaries and bonuses, customers judged the fairness of the business, the government charged taxes and shareholders demanded dividends. In contrast, the fair valuation of investments may result in accelerating the eventual distribution of income among stakeholders, especially dominant shareholders[11] and executive managers. The fair value accounting model

[10] According to Khotari, Ramanna and Skinner (2010), verifiability and conservatism are critical features of accounting standards, since their main focus remains on control (performance measurement and stewardship).

[11] Holderness (2007) provides a relevant critique of dispersed shareholding in the US share market. Cf. also Aglietta and Rebérioux (2005).

may allow value-sharing among stakeholders quite independently from the *actual* productive efforts and results through time. Even in the case of (portfolios of) traded financial assets, the fair value model results in basing accountability and value-sharing on estimates that may be of billions of dollars positive one day, and billions of dollars negative in few weeks. What if the trader's bonus was paid in the meanwhile?

3.10 Is fair value, accounting?

In sum, the new fair value accounting model appears to increase assets by taking into account expected future revenues, to decrease liabilities by discounting them to their current values, and then to inflate accounting of shareholders' equity, in order to better relate the latter to ever changing quotations on the share Exchange. In so doing, however, this model may be at odds with the relevant and reliable representation of the enterprise economic process. In purporting to follow the market reference (in "Newspeak" wording, to be more useful for investment decision-making), this model seriously risks becoming less relevant and reliable for *making sense* in the economic organization of the business firm, in Weick (1995)'s terms. It may undermine then its fundamental role in the institutional structure(s) of production in economy and society.

The historical cost accounting logic is generally appreciated as being *reliable*, and traceable. But, in response to these problems with fair value, can an accounting setting based on cost (and revenue) accounting improve the *relevance* of financial reporting? The following section will address this question by discussing the case of intangibles and the distinction among equity and liabilities. To be sure, this focus on asset and liability concepts neglects the fundamental issue of the economic entity behind its legal form, including the matter of enterprise groups (Strasser and Blumberg 2010; Robé 2010). In the latter context, the accounting question is not so much related to the accounting for single elements, as to the actual economic stakes of the business enterprise over and beyond its legal appearances. The so-called off-balance sheet operations are not *off* the flow of financial and economic relationships of the enterprise entity that accounting should represent.

4. Generating Alternatives to Fair Value Accounting and Reporting

4.1 The new notion of asset according to the fair value perspective

The rewriting of the concept of asset in the IASB's conceptual framework is a typical case of the apparent Orwellian linguistic strategy. The previous definition stated that

> An asset is (i) a resource (ii) controlled by the enterprise (iii) as a result of past events and (iv) from which future economic benefits are expected to flow (v) to the enterprise (IASB, Framework, par. 49a)

The provisional draft of the new definition states that an asset is

> a present economic resource to which an entity has a present right or other privileged access (IASB 2006b, 4).

Interestingly, the new definition maintains the generic reference to the underlying resource (point *i*), but excludes any reference to the temporal process (past results and future benefits, points *iii* and *iv*) and shifts the notion of control towards a legally-enforceable basis (point *ii*) without reference to the resource's use in the enterprise (point *v*). In addition, the resource is now "economic" since it is expected to have an intrinsic economic value based on discounting.

In this way, the new definition contradicts all the other conceptual frameworks surveyed by IASB (2006b, 12), but it is increasingly in line with the primary bases of asset measurement retained by IASB DP (2005), which reflect a form of current value based on discounting. "Fair value", "net realizable value", and "value in use" all reflect a present value calculation (implicit or explicit) of estimated net future cash flows expected from an asset (see also IAS 36, BCZ11).[12] In a perfect (efficient) market for the asset, all of these calculations will result in the same amount. Therefore, the IASB DP (2005) establishes a clear preference for a financial logic based on market value that corresponds with discounting. The latter is supposed to provide a "rational" consideration of "time value of money" (see also IAS 36, §B24 ver. 1998; IAS36, §BCZ13, §BCZ52-55).

[12] The current or replacement cost is more difficult to grasp, but it should correspond with the current market price, whenever the asset is replaceable through a market transaction.

4.2 Cost accounting logic is neglected

This pursuit of discounting is regardless of the current measurement basis that has been already conceptually adopted by the IASB, and strikingly contrasts with the well-established distinction between "invested cost" (enterprise process-based) and "current value" (market-based) measurement perspectives. Even though the IASB takes into consideration both "fair value" and "value in use", this does not provide a synthesis of these two perspectives (market-basis and enterprise process-basis), since discounted present value has replaced invested (historical) cost which, according to Littleton (1935) and Ijiri (1980), is the proper basis of the definition of "value in use".[13] The IASB disregards therefore the distinction between value and cost. Even in the case of the "value in use" of an asset involved in some "cash generating units", where the asset produces cash flows in combination with other assets, the fair value measurement requires splitting the change in value of single assets according to a piecemeal approach. Following the IASB's approach, then, the combination is disregarded as a unit of accounting, and assets are always (expected to be) "disposable" from the viewpoint of the "rational enterprise" (see also IAS 36, B34).[14]

In contrast, following the process-basis perspective which supports the cost accounting logic, *useful* assets may never be disposed of without encountering the loss of the *synergies* resulting from their combination in the "cash generating unit", and the loss of competitive advantage that fosters business income generation. From this cost accounting perspective, both the "cash generating units" and the enterprise entity which pools them together, imply a dynamic and holistic concern which characterizes the nature of the enterprise entity (Biondi 2005, 2006, 2007).

4.3 Where does an asset come from?

Therefore, the piecemeal approach adopted by the IASB and the comprehensive approach based on historical cost accounting result in different notions of asset (Table II above). The IASB's approach is clearly following fair value accounting. Fair value accounting identifies resources which have a legal or material basis, which makes them marketable. The related asset is then evaluated on a market

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[13] In fact, Paton (1946) disagreed with Littleton (1953) on this point. Paton argued that "cost (…) is important as a measure of the value of what is acquired" (p. 193b), while Littleton spoke about "an unending clash of the idea of value and the idea of cost" (p. 10b). cf also Paton (1980) on his preference for value basis.

[14] According to IAS (36, B34, ver. 1998) and IAS (36, BCZ22), the benchmark measurement for the disposal of the asset is the positive difference between its net selling price and its value in use, the latter being defined as the sum of discounted cash flows generated by that asset in isolation.

basis. For example, the preference for market basis is the main reason underpinning the refutation of "deferred charges" as useful assets which may be capitalised and amortised, since these immaterial resources exist only in the ongoing process of the enterprise entity that is expected to recover them.

In contrast, cost accounting refuses to account for the asset's value, since this requires the anticipation of future benefits from use or resale. The cost approach capitalizes instead the related expenditures and amortizes them on the basis of the useful life of the underlying resource. No legal or material existence is required for this capitalization, merely the resource's usefulness beyond the period of reference. The accounting representation of the related asset starts from the actual historical operation and the related monetary outflows. Both a fair value theorist like Bonbright (1937, chap. XXVI, 902-906) and a cost accounting theorist like Littleton (1935) explained this point by the difference between accounting for the value or for the cost. In particular, cost accounting complies with the logical autonomy between costs and revenues in accounting for the ongoing enterprise process. In principle, sales to customers are ultimately realized and generate economic income for the recovery of incurred costs.[15] The cost accounting logic keeps the cost and revenue streams distinct and thus avoids the impact of "revealed" figures of *unrealized virtual* benefits, and the effect of unreliable discount rates on accounting numbers. In contrast, fair value accounting relies on the discounting method that requires this double impact and sharply contrasts with the accounting role of *accountability* which "has clearly been the social and organizational backbone of accounting for centuries" (Ijiri, 1975, 32).[16]

4.4 The case of intangibles

In sum, in order to recognize an asset, fair value accounting seeks to estimate the spot value of the resource (current, market or present value) in isolation, whilst cost accounting focuses on actual streams of expenditures to provide a reliable representation of resources as invested costs. The latter are eventually matched against revenues on an enterprise process basis.[17] The accounting determination of the invested costs corresponds with the monetary expenditures that were incurred to support the investment in the asset, whether tangible or intangible, marketable or not marketable.

[15] Another reason to argue against the IASB argument for disposal of productive useful assets (compare IAS 36, BCZ22).

[16] Even Anthony (1983) argues for cost accounting when reliability is the priority.

[17] This does not exclude some supplementary disclosure based on the fair value approach but independent from the income statement, see below.

The difference between the cost and value approaches is straightforward when investments in intangible assets are considered. Contrary to current wisdom, cost approach does not require estimating the current economic value of investments, and does not prevent the recognition of investments in intangibles *at their cost*. Ijiri (1975, 140, *with adjustments*) clearly explained this point:

> [the capitalization and amortization of research and development costs, intangible drilling costs and deferred charges, as well as of hiring, training and relocation costs related to human resources] is a method which accepts historical cost as the valuation principle […] and advocates a better matching of costs and benefits […]. Currently, these costs are expensed in the period in which they accrue, but the proposed change is to capitalize them and amortize them over the expected service life of the [related resources].

In the case of "internally generated intangibles" (in "Newspeak" wording), fair value accounting adopts a financial logic and relates the valuation of intangibles to the market valuation of the business entity as a whole. According to IAS38, this makes it impossible to distinguish "the cost of generating an intangible asset internally […] from the cost of maintaining or enhancing the enterprise's internally generated goodwill or of running day-to-day operations" (IAS38, §39, b, ver. 1998; IAS38, §51, b). Furthermore, fair value accounting requires an emphasis on the legal form of separable resources (IAS38, §12) instead of their economic substance, as IAS38 (par 49) clearly explains: "Internally generated goodwill is not recognized as an asset because it is not an identifiable resource (ie it is not separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost." In contrast, cost accounting may recognize intangible assets on the basis of the actual expenditures that correspond to useful resources, even internally generated ones. This does not require recording either some conditional actualization of future benefits, or current market valuations, but establishing *reliable* conventions to capitalize and amortize these expenditures.

The case of acquired intangibles confirms the market preference adopted by fair value accounting. The intangibles are often acquired in the context of a business combination and are treated as a part of acquisition goodwill. According to IAS (38, §B25 ver. 1998):[18] "It is assumed that [specific recognition] criteria are met implicitly whenever an enterprise acquires an intangible asset. Therefore, IAS 38 requires an enterprise to demonstrate that these criteria are met for internally generated intangible assets." Once again, this means that the financial

[18] See also IAS38 (§25 and §33) and IAS38 (§B29, b, ver. 1998; IAS38, §51).

logic is retained, which is ultimately biased in favor of market reference and valuation. This links *reliability* to market-based estimates (IAS38, §39). Therefore, fair value accounting trusts the reliability of ever changing market quotations, and denies asset status to many actual expenditures (IAS38, §6, ver. 1998; IAS38, §63-64) that a pure cost accounting logic may capitalize and amortize (including deferred charges).

In sum, the historical cost capitalization method allows the firm to allocate intangibles costs on several periods and thus on several costumers, enhancing its force as socio-economic device for socio-economic development. Such capitalization of costs invested in intangibles is advocated by Lev and Zarowin (1999: 376 ff.) in order to enhance the usefulness of accounting information, whilst Basu and Waymire (2008) develop a thought-provoking perspective against expanded reporting of intangible asset *values* in corporate balance sheets. This method actually excludes non-monetary resources (or part of them) whose imputable costs cannot be determined, even though they contribute to the ongoing processes of the enterprise entity. Some non-monetary measurement systems of these "internally generated intangibles" may then be disclosed in supplementary statements together with standardized narrative information (Benston et al. 2003, reviewed by Biondi 2007; Biondi and Rebérioux 2008).

4.5 The distinction between equities and liabilities

A further look at the liability side of the balance sheet will shed light on the misunderstandings involved by a move toward the fair value approach which grapples with the distinction among equities and liabilities. This distinction is fundamental to its overarching ownership perspective discussed above. From the fair value perspective, the vital distinction is among equities and liabilities as distinct parts of the committed (entrusted) financial resources. This focus neglects the relationship that investors engage with the enterprise entity. From the entity perspective, the main distinction is between the business capital invested by risk-takers and capital accumulated from operating the business at a profit (Littleton 1938). The entity perspective that supports historical cost (and revenue) accounting is based then on the double separation between ownership and management, and between shareholding and the business venture (Biondi et al. 2007). From the entity perspective, then, firms may and will acquire financing from several other sources than shares, including debts and self-financing, whilst shareholders have no longer to bear the risks and potential losses beyond their own financial contribution to the business venture.

Consequently, the shareholders' net equity (roughly, paid-in capital) constitutes a special source of financing for the enterprise entity. As Schumpeter early justified (Biondi 2008), this source of financing is a special liability for the firm as an entity. Accordingly, accounting may recognize the income allocated to this source of financing either by calculating an "equity interest" on the actual funds provided in the past (Anthony 1983), or by disposing a conventional part of net earnings to the shareholders (as the current German regulation does). Attach a cost on each kind of financial sources is much more practicable, reliable, and cheap than put an expected value on them. The level of this "equity interest" may be disclosed by financial statements.

Drawing upon historical cost accounting perspective, the actual determination of "equity interest" further implies the distinction between shareholders' equity and the entity's equity. This distinction completes the articulation of external sources of financing between equities and liabilities. The entity's equity will be composed primarily of retained earnings that may be eventually distributed to other recipients than shareholders (Biondi 2005; Anthony 1983).[19] The further distinction among shareholders' equity, minority interests and other liabilities may then be based not on financial, but governance and legal features of the underlying financing entitlement and relationship.

From the cost accounting perspective, even accounting for financial liabilities and other sophisticated financial instruments (including hedging) may require not to look after their expected net value, but to the subsequent monetary flows that they may provoke and their impact on the allocation of enterprise incomes through time. In particular, hedging has the goal of generating profit by taking specified risks subject to value-at-risk management controls. Accounting for hedging *at full fair value* implies to reflect financial change in potential gains and losses from the hedged portfolio of assets and liabilities at a specific point in time. This marking-to-market accounting could dramatically affect the underlying economics of banks or insurance companies. According to Sapra (2006) and Boyer (2007), these financial institutions would be forced to hold shorter-term loans to look better on their financial statements and performance, whilst their role in the economy is supposed to be that of providing liquidity through making long-term illiquid loans (as assets) by holding short-term deposits (as liabilities). On the contrary, accounting for hedging *at cost* implies to reflect the engaged overall (gross) positions and the financial income generated by eventually realising these positions through time. A further reconsideration of their role in the overall economics of those entities would be also required. Eventually, some objectives of financial security may be obtained by other regulations and standardisations than enhanced disclosure, either at value or cost (Stout 2010; Biondi 2010).

This section has disentangled the impact of a move towards fair value accounting for two specific examples regarding the fundamental notions of asset

[19] Entity's equity may also include provisions for risks and engagements limiting the distribution of earnings to shareholders through dividends and share repurchases.

and liability. In both cases, this section has also showed that practicable accounting solutions may be developed under cost (and revenue) accounting. By accounting for intangibles, shareholders' equity interest, and enterprise entity equity following the historical cost approach, these solutions are supposed to be both reliable whilst improving on the relevance of financial statements from the informational viewpoint (Terrill 2010). The following section will go further on the informational content of the accounting representation by addressing the different approaches by fair value and historical cost (and revenue) accounting to the matter.

5. Performance, time and the investors: the historical cost perspective

5.1 The alleged direct link between accounting numbers and share prices

According to the former FASB President, Robert H. Hertz (2002):

> It's hard to argue with the conceptual merits of fair value as the most relevant measurement attribute. Certainly, to those who say that accounting should reflect better true economic substance, fair value, rather than historical cost, would generally seem to be the better measure.

However, following the traditional accountability framework, cost accounting contrasts with discounting, as May (1936, 19) recognized:

> […] what the investor or speculator is interested in is the value of the business as a whole, and that is dependent mainly on what it will produce [and sell] in the future and is not determinable by any purely accounting process. […] (B)ut if the accountant were to assume the task of valuing the business as a whole, he would have met the assumed need, and it would be entirely supererogatory for him to attempt to allocate that value as between the different assets of the business.

From this traditional viewpoint, the link between accounting numbers and market quotations - either for assets, liabilities, or the business entity as a whole - is not straightforward. However, many nowadays minimize the distance and applaud the fair value approach for finally accepting economic rationality and providing relevant information for financial decisions.

This claim may be based on a limited understanding of the dynamics of the share Exchange. Fair value accounting pays attention to the matter only from the perspective of complete and perfect financial markets ("efficient financial markets"). Under the hypothesis of marketability of all of the productive factors and commodities, the share prices are the best information device. Accounting does not matter, but must follow.

However, the key point may be not so much a pataphysical "market efficiency" as the very pattern which makes markets effective. The making of the share Exchange should not be neglected. As a matter of fact, shareholders usually are second-hand buyers of shares sold by the firm (in fact, issued by one corporation involved by the firm's legal form) to a syndicate of investment bankers for a negotiated price or on a best-efforts basis for a fixed fee. Most of the trading volume on the stock market occurs afterwards, among investors having different purposes and strategies; and financial organizations having their own strategies and structures (including accounting systems); and also the firm itself, through treasury stock, share repurchase and other open market operations. As Shubik (1993) and Sunder (1997, 97-111) recognize, the empirical approach which looks for a direct link between accounting numbers and market quotations does neglect price formation, overhead allocations, carried immobilizations, and all of the concerns which lay at the core of everyday business activity.

5.2 Accounting system does complement and not follow the price system

In the making of the share Exchange, business norms and knowledge provided by institutions external to the market (Sunder 2005) play a significant role under conditions of unfolding change, hazard and limited knowledge. Share Exchange participants are assumed to estimate the (potential) profitability of the firm based on discounting the future for the "time value of money." As a matter of fact, investors' gain comes only indirectly from this fundamental value, and directly from actual dividends (and share buy-back and other distributions) and the continuous changes in stock prices, which in turn depend on investors' actual share-holding duration and time horizon.[20] Theoretically speaking, investors are then confronted with two distinctive sources of information and incentive in both the monetary and the epistemic dimension of the Share Exchange. Concerning the monetary dimension, every investor forms his own expectations on both the dividend flow and the equity premium on share market price. The individual

[20] According to Folkman and al. (2006), "over the period 1983-2002, share price appreciation accounted for 63 per cent of total shareholder returns (TSR) in UK FTSE 100 firms and 70 per cent in the S&P500".

investor's financial return (pay-off) depends from one side on the market price he may obtain by selling his shares (or the market price he should pay for buying the firm's shares), from another side on the dividend flow that is distributed by the business firm and is established according to accounting regulation among others. Concerning the epistemic dimension, the individual investor's decision-making deals with two information flows provided by distinctive institutional structures. One flow of information is generated by the Share Exchange and is subsumed by the formation of aggregate (collective) pricing through time. Another (collective) flow comes from accounting and other regulatory institutions that frame the market, and that facilitate the working of the share market itself (Frydman 1982: 664).

Therefore, the price system and the accounting system complement each other in driving the market price formation trough time. The general system (which is no longer an equilibrium) consists in and depends upon the coherence and universal diffusion of relevant and reliable knowledge by means of both a price system and an accounting system publicly determined and announced. The current period, in-between *ex ante* and *ex post*, locates here among future time, submitted to individual guesses and intentions, hopes and fears, and past time, a history of reporting that, in principle, may be partly public, consistent, and conventionally agreed (Shackle 1967, p. 257-258). In this context, the financial reporting provided by the accounting system generates common knowledge (Sunder 2002) on the financial performance and position generated by the business firm over time. It delivers relevant and reliable signals that are shared by heterogeneous investors which do not know (or do not agree on) one unique fundamental value of the traded securities issued by the firm.

5.3 The accounting lighthouse

This understanding completely changes the role that accounting may play in the dynamics of the Share Exchange (Biondi 2003, Biondi and Giannoccolo 2009 and 2010). In this dynamic and strategic context, the accounting system and its own logic are expected to provide common knowledge that contributes to the market pricing over time.[21] Accounting information plays then its role as a lighthouse *for* the market, not a mere follows-up *from* market prices. In turn, instead of requiring accountants to become (bad) econometricians or to mimic chartist analysts, the accounting representation may be expanded according to its own scope of accountability. Ijiri (1975, ix) relates this scope to the very nature of accounting:

[21] Hirota and Sunder (2007) attribute this role of common knowledge to dividends in an experimental making of the share Exchange.

> Accounting is a system designed to facilitate the smooth functioning of accountability relationships among interested parties […] in contrast to the widespread idea that accounting is a system for providing information useful for economic decisions. […] the latter […] focuses only upon the relationship between the accountant and the decision maker and does not deal with the important relationship between the decision maker and the entity whose activities are being reported.

From this perspective, accounting information may provide relevant and reliable information about, and confirmation of the (actual) performance of the firm through time, as long as transactions are completed and the potential becomes actual. As accounting does control for the generated performance of the business firm, and match it with the allocation of enterprise incomes (dividends, among others) to stakeholders (including shareholders) with respect to the continuity of their joint concern through time.

5.4 The accounting representation of business income

According to Beaver and Demski (1979: 38), income measurement "exists and is open to a straightforward present-value interpretation in the usual economic setting of perfect and complete markets. Unfortunately, these market assumptions render the measure superfluous." Beyond that setting, reported income does not exist *as a measure* in the fundamental sense. As a consequence, in a world that lacks in perfect and complete markets, accounting cannot longer have recourse to market *measures* of assets and liabilities that have some physical or legal reality making them marketable. This lack may be destructive if accounting is considered as mere "information," but it does not prevent to consider accounting as a "representation", that is, a form of knowledge having informational content. Accounting focus is no longer on *measuring* separable assets and liabilities, but on a comprehensive *representation* of enterprise capital and income to the whole firm through time. Accounting representation may then "make sense" of the economics of the firm as an economic entity and a going concern for various stakeholders, including shareholders.

These are the representational purpose and scope that lye at the core of the historical cost (and revenue) approach. The business firm is then understood as an historical entity, located in time and space, and having its own path of development which historical accounting helps to illustrate, organize, and regulate (Biondi 2005). Indeed, *the accounting information does complement and not follow market information*. At least fundamental and strategic analysts insist for management provides them with a "history" of the business enterprise. This history is not a "revelation" story based on self-standing declarations, but a comprehensive representation of events and facts that accounts for operations and results over time, and establishes a reasonable basis for understanding the future scenario that management is figuring out. In this context, disclosure provides business income determination and a structured synthesis based on the ongoing process of the enterprise entity during the reference period. The continuity of the enterprise entity is the main securitization for all the interests relying on the firm for their satisfaction. Since the working of the accounting system affects the creation and allocation of the business incomes, cost accounting generally is better designed to determine the actual performance in a way that does settle divergent interests (Ijiri 1975).[22] Accounting may then fulfill its mission of accountability and control in an economic context fraught with immanent conflicts of interest.

The suggested understanding of accounting requires reconsidering fundamental notions of both relevance and reliability, and the supposed purpose of accounting for shareholder value. These points will deserve specific attention in the following.

5.5 Relevance and reliability reconsidered

Following its Orwellian linguistic strategy, the IASB (2006a) project has purported to remove the word "reliability" from the qualitative characteristics of financial measurement. This notion should be displaced and perhaps encompassed by that of « faithful representation »; together with relevance (value relevance), they become the "fundamental qualitative characteristics" of financial reporting. This drift has been implemented with the new Conceptual Framework adopted by IASB since September 2010.

However, both reliability and relevance acquire distinctive meanings according to fair value and cost accounting perspectives (Table 4).

Table 4 – Relevance and reliability according to fair value and cost accounting perspectives

	Fair value	Cost
Relevance, to	Value of the firm	Incomes actually generated
Reliability, through	Current values (market or discounted)	Actual economic and monetary process

[22] Zingales and Novaes (2003) attribute this role to the bureaucracy within the economics of the firm.

Relevance and reliability, therefore, are substitute as well as complementary qualities *relative to the overarching accounting perspective*. Whilst fair value accounting discloses a *full of "faith"* representation *relevant* to know the value of the firm, cost accounting constitutes a *reliable* synthesis *relevant* to know the actual generation of incomes to the enterprise entity through time and hazard. According to cost accounting, both qualitative characteristics cannot be satisfied through a focus on measures of separable assets and liabilities, but through the overall objective of representing the ongoing economy of the enterprise entity as a whole.

5.6 The problem with the fair value perspective

The problem with the fair value perspective comes from its underpinned perspective on efficient financial markets and share-holding. Fair value relies on perfect and complete financial markets. Investors are then considered as fully clear-sighted traders adjusting promptly and without costs to price signals, "as if" the *price system* alone framed and shaped the dynamic of both financial markets and the firm. But what happens when holding shares - acquired to a definite price - relates to a somewhat unknown (and unaddressed) congeries of a legal and economic system involving flows and immobilisations that requires an *accounting system* to deal with them?

This is the factual environment of every business firm. In the enterprise context, the fair value idea grapples with offering an instantaneous valuation of the firm in line with the valuation offered by the share Exchange. The accounting system is then supposed to mimic the price system, even though the ongoing economy of the firm performs incomes only in historical time. The consequences for the representation of the economics of the business firm are material. In particular:

- Estimates of current values of assets do inflate the accounting representation of the business capitals;
- Estimates of current values of liabilities do muddle the apprehension of overall debt outstanding and service through time;
- Taken together, this whole of estimates makes the accounting representation of business incomes very sensitive to errors and biases on the capital stock net value, since the change in the income level – defined here as difference between two subsequent values of capital stock - is a

huge multiple of the changes in related capital stock values (Lim and Sunder 1991; Peasnell 2006, 7-8).[23]

This is why the Hicksian definition of income as change in wealth (capital stock values) - the main theoretical reference underpinning the fair value approach - does not fit the traditional accounting logic, as agreed by Bonbright (1937, chap. XXVI, 894 ff., especially 902-906) who developed the "value to the owner" concept. Even from such old-fashioned proprietary viewpoint, the "stewardship" of management towards proprietors does not regard fair values that are forward-looking and quite independent from managerial actions, but the managerial accountability for pursued actions and actual results according to intended purposes. This is the very traditional message of "prudence" and "conservatism," which stress reliable and verifiable accounting numbers (and representation) in a context fraught with immanent conflicts of interest, asymmetries, and moral hazard (Weigmann 1932; Basu 1997; Watts 2003; Cunningham 2005; Lafond and Watts 2007).

For investors do actually invest in the business venture (not only in their own shares), the cost accounting approach may better fit this "stewardship" function by informing investors through a logical chain of cumulative milestones that track generated business performance that has been sustained through time. Once disclosed, this information becomes common knowledge that provides an accounting lighthouse for investors (and the market dynamics) to form proper expectations and share prices (Sunder 2001, 2005; Hirota and Sunder 2008; Biondi 2003).

5.7 The cost accounting approach to the value of the firm to shareholders

As Bonbright (1937, chap. XXVI, 910-911) recognized, basing the accounting system on values that the accounting system simultaneously helps to evaluate is problematic and might lead to inconsistencies and impracticability. This way, the value disclosure might involve reverberation effects, reinforce share market exuberance and thus undermine price formation in financial markets (Penman 2006; Boyer 2007, both providing further references). In addition, according to Aglietta and Rebérioux (2005), fair value accounting may push management to narrowly focalize on short-term increases in the share price, which profit to trading gamblers with short-term horizons and executives who want to realize their stock options, without consideration of investors and other stakeholders that

[23] In the example provided by Peasnell, "a balance sheet error of plus or minus 10% has magnified into a profit or loss error of 81%".

hold on interests for the longer term and are likely to bear the eventual detrimental effects of such policy.

In this unfolding and hazardous economic context, the cost accounting perspective definitively distinguishes the (shareholder) value of the firm and the book value reported by financial statements. Financial statements are then devoted to determining the generated performance of the firm through time. Contrary to the IFRS argument (IAS 36, §B24, point e, ver. 1998; IAS36, §BCZ13, §BCZ52-55), users are perfectly aware that cost-based financial statements do not include the recovery of "time value of money," since the latter notion belongs to the financial logic that is essentially different.

This distinction does not prevent the use of accounting information to estimate the (shareholder) value of the firm. On the contrary, cost accounting may be the proper basis for valuing the firm. As Penman (2006, 23) argues, since the cost approach misrepresents balance sheet values and thus undermines stock based valuation, the valuation process can be achieved starting from the representation of sustainable earnings on a flow basis. For applying this flow method, a conventional part of earnings or an annual equity interest (i.e., rate of return) for shareholders' equity may be disclosed. The latter disclosure fits with the recognition of the *cost* of shareholders' equity as claimed by Anthony (1983).[24] As discussed above, this equity interest will be coupled with the distinction among shareholders' equity and entity's equity. Heuristic views of balance sheet and income statement from this improved historical cost perspective are provided in Tables 5 and 6.

[24] This recognition corresponds to what economic rationality and financial logic does with "time value of money."

Table 5 – A "balance sheet" heuristic view from the cost accounting perspective

ASSETS		SOURCES OF FUNDS	
1. Prices-related values	(cash, commercial claims to cash)	3. Prices-related liabilities (commercial debts)	
2a. **Costs invested**	(expenditures capitalized, overheads, immobilizations)	4a. **Revenues advanced**	(funds supplied, liabilities incurred, earned revenues capitalized)
2b. Investments	(participations in non-related entities, which are not consolidated)	4b. Shareholders' equity	(net funds supplied plus *unpaid equity interest*)*
5. Net income cumulated (if negative)		5. Net income cumulated (if positive)	(cumulative difference between costs and revenues, including net income of the period)

Table 6 – An "income statement" heuristic view from the cost accounting perspective

Revenues
minus expense transactions with non-related entities (that become revenues to those entities)
Gross income generated
minus Allocations and distributions: • Salaries • Amortizations and Depreciations • Interests • Taxes
Net Income generated
Allocation between : • Dividends (compensated with "equity interest" or "shareholders' quota" in the shareholders' equity) and • Retained earnings (in the entity's equity, or available for distribution to other recipients than shareholders)

In conclusion, the pure logic of accounting allows improving its informational content without renouncing to the purpose and scope of

* Here we are including *equity interest* calculation on net funds actually provided by shareholders as dynamic sources of funds (financial resources).

accountability that has ever been the cornerstone of the accounting representation. From the informational viewpoint, a first improvement may be to provide further disclosure about the permanence and stability of the streams of revenue. The usual machinery of cost allocation may be extended to actual revenues which are already entitled to the entity (accrued) and will be earned through continuing operations beyond the period of reference.[25] Furthermore, fair value information may at best be disclosed by supplementary financial statements, as previous accounting systems have done with respect to the cash flow statements (which was at the core of an early wave of criticism against the accounting model based on invested cost and generated revenue). The supplementary disclosure will keep fair value estimates out of business income determination and allocation.

Conclusion

The ongoing international accounting convergence fundamentally increases the need for sound accounting principles as a basis for accounting rule-making. However, the so-called fair value revolution has fostered a revolt against classic accounting principles, synthesizing all the "criticisms against historical cost [that] have been launched from all corners, by academicians as well as practitioners. In fact, the accounting literature is so decisively against historical cost that only hardcore traditionalists seem to uphold historical cost" (Ijiri, 1975, 85). At the same time, the current shift towards fair value accounting is generating public debate against this approach. Summarized by Penman (2006, 1), these arguments point out the dangers of disclosing fair value estimates from subjective models rather than marking to market; they also raise concerns about introducing "excess volatility" into earnings and the feedback effects on business practices and institutional rules that could damage a business and even heighten systemic risk, as well as the overall misunderstanding of the economics of the business firm itself. Furthermore, studies like those of Capron (2005) and Aglietta and Rebérioux (2005) accuse the fair value revolution of fostering a narrow financial view of firms and thereby overlooking a "fair" representation which makes entities accountable to all the stakeholders relying on the enterprise entity.

This paper has attempted to criticize the fair value revolution by a throughout reconsideration of the views of traditional historical cost accounting. Whilst fair value accounting focalizes on the market reference, the cost accounting focus is on the economic and monetary process generated by the

[25] The financial statements of Computer Associates since 2001 provide an example of this innovation (Biondi 2003). Please note that the legal prosecution by the SEC did not concern this innovative method, which appears to be partly considered by the ongoing "revenue recognition" project by FASB and IASB as the "costumer consideration model" (Tweedie 2006: 16).

whole enterprise as an economic entity and a going concern. The dualistic approach between cost and value accounting models has been applied to illuminate certain accounting issues raised by the fair value revolution, including its accounting for intangibles and the distinction between equities and liabilities. Some improvements of the cost accounting system in line with the traditional logic of accountability have been discussed, and related heuristic views of the financial statements have been provided.

In summary, the working of the accounting system requires some basic premises about the underlying economics of the business firm. The fair value revolution adumbrates the firm as a financial trust devoted to the cash enrichment of shareholders as its beneficiaries and trustees. Accounting is then confused with other forms of financial communication and advertising *on* the firm as a financial placement. However, the business firm can be and has been understood as a relatively enduring system of relationships comprising flows and linkages that involve resources from different stakeholders and governance structures for the joint accomplishment of individual and collective goals. The accounting system is then an integral part of this socio-economic system (Zappa 1937; Biondi et al. 2007; see also Swanson and Miller 1989). From this perspective, the relationship between accounting numbers and the share Exchange should not preclude accounting's public interest role as a mode of regulating, organizing, and representing the enterprise entity through a more comprehensive approach. Nor is it necessary to disregard cost accounting for subjective valuations based on discounting. For the traditional cost accounting provides information that represents a shared, disclosed, and actual determination of the incomes to the firm (Biondi 2003). This *reliable* information provides a common base of knowledge that is both *relevant* to investors for their subjective valuations and decision-making (Sunder 2001), and *fair* for accounting for business and society.

Accounting and accountability are by no means unconcerned with socio-economic polity. The accounting system is not an exercise in financial advertising, but it is instead the "language of business" that is embedded in the making of the socio-economic system, where language mediates and maps context. The quest for accounting principles, then, is not academic. Accounting principles are an integral part of the governance and the regulation of the socio-economic system. They play the same role in the accounting system that the constitution does in the legal system. They must therefore provide each actor (especially management and law court judges) with a clue to comprehending the socio-economic dynamics of the joint becoming concern and to undertaking a "fair" conduct of business (Williams 1987; Thaler et al. 1986). Together with the price system on the market, the working of the accounting system affects the economic creation and allocation of resources within the firm, and in economy and society at large.

Therefore, accounting principles need to take into account "other people interests" and to have regard for the public interest. From this perspective, the pure logic of accounting still rests on the classic accounting principles of (i) the firm as an economic entity and a going concern, (ii) matching, and (iii) invested cost and generated revenue. Accordingly, the enterprise entity is clearly distinct from the wealth of its shareholders and from fluctuating changes in share value on the open market. The accounting system is then a *mode of representing, organizing, and regulating* the special economic and monetary process of the firm as an enterprise entity.

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